

Tax Supported New Issue

State of Vermont

Rating

General Obligation Bonds AA+

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New Issue Details

\$118,595,000 General Obligation Refunding Bonds, 2004 Series A, expected Feb. 2 through negotiation with Citigroup and UBS Financial Services, Inc. Bonds will be due Feb. 1, but maturities and call features are not yet determined.

Security: General obligations of the State of Vermont; full faith and credit pledged.

■ Outlook

Vermont's conservative approach to debt and financial operations provides a strong foundation for high credit quality. During the protracted recession period of the early 1990s, the state assiduously followed an austere recovery program, demonstrating well its willingness to take appropriate action for stability. Following recovery, its reserves were fully funded, expenditure levels remained under control and substantial surplus was used for capital purposes, allowing debt to decline. The state's economy weakened in 2001–02 and revenues were below projections. Appropriations were cut but partial use of the reserve was still necessary. Operations subsequently have been favorable and reserves are being re-built.

■ Rating Considerations

Important to Vermont's long-term credit assessment is the demonstrated willingness to keep debt within manageable parameters and fidelity to the simplicity of debt structure, having used faith and credit obligations almost exclusively and, since a refunding in 1998 virtually all direct debt is again general obligation. Debt has declined for five consecutive years, debt ratios are moderate, and amortization is rapid. In line with affordability recommendations, annual borrowing has been reduced, and considerable capital needs have been met from cash, not bonding.

Financial operations were successful for the six years through 2001. After elimination of the deficit in 1995–96, the rebuilding of the budget stabilization reserve commenced followed by the setting up of further reserves for education and welfare as well as the use of current surplus for capital purposes. The stabilization reserve became fully funded at 5% of revenues. Revenues, driven by the personal income tax, consistently exceeded estimates until weakness surfaced in 2001. The personal income tax dropped, reflected a sharply lower capital gains base, the recession dampened withholdings and corporate taxes were disappointing. Despite expenditure measures, over half of the reserve was tapped in fiscal 2002. In fiscal 2003 revenues exceeded estimates and surplus funds were diverted to reserves. This year revenues are also ahead of estimates and full funding of reserves is anticipated. The governor has recommended lowering the rate of the personal income tax to be balanced from ending capital gains exclusion and closing corporate loopholes.

Vermont lost about 5% of employment in the early 1990s recession, but by 1994, employment had exceeded the pre-recession level. However, manufacturing employment, higher paying than the services sector, was slower to recover. While good gains were made, jobs in the sector remained below the 1980's level. With the 2001 recession,

manufacturing declined again. Although services have grown, the transformation tends to slow personal income expansion.

■ Strengths

- Virtually exclusive use of general obligations.
- Moderate and declining debt ratios, with affordability planning.
- Generally conservative policies.
- Reserves built during strong financial period.
- Deficit plan followed in adverse situation.

■ Risks

- Some vulnerability through manufacturing importance.
- Revenues have not consistently been meeting estimates.

■ Debt Position

Vermont has a favorable debt position with no constitutional or statutory restrictions. All direct debt is now general obligation, as a minor amount of leases and certificates of participation (COPs) were refunded in 1998. The bonds which refunded the leases and COPs are treated as special fund bonds, for internal cost accounting purposes, but are actually general purpose obligations. General purpose bonds are serviced from the general fund and highway debt from the transportation fund. Not included in debt is that issued by the Education and Health Building Finance Agency for the benefit of developmental and mental health services provider although much support for the programs is from state appropriations.

There is considerable exposure through credit extension, although it was significantly reduced with the sale of the portfolio of the Vermont Home Mortgage Board, which had liabilities of \$117 million in 1998. The state's full faith and credit backs up certain programs of the Vermont Economic Development Authority (VEDA), including the insuring of \$15 million mortgages, and is authorized to reimburse lenders participating in the Financial Access Program to a maximum of \$2 million. Mortgages amounted to \$5.0 million and the reimbursement liability was about \$1 million. VEDA has issued commercial paper (\$34 million outstanding) for financing new loans; the commercial paper program has a reserve deficiency make-up provision with the state, not to exceed \$55 million. Calls on the various guarantees have been minor. There are reserve fund deficiency make-up

Debt Statistics (\$000)

General Obligation Bonds	
General Purpose: Outstanding	435,199
To Be Issued*	160,595
Transportation Bonds	<u>13,049</u>
Total G.O. Bonds	608,843
Revenue Anticipation Notes (RANs)	48,000

Contingent Liabilities	
Economic Development Authority	6,013

Reserve Fund Commitments	
Bond Bank	415,730
Housing Finance Agency	75,940
Economic Development Authority	<u>55,000</u>
Gross Debt	1,209,526
Less: Contingent Liabilities and	552,683
Reserve Fund Commitments	114,890
RANs G.O. Being Refunded	<u>48,000</u>
Net Tax-Supported Debt	493,953

Debt Ratios	
Per Capita (\$)	811 (608,827, 2000)
% Estimated Full Value	1.1 (\$46,929,258,396, 2002)
% Personal Income	2.7 (\$18,167,000,000, 2002)

Debt Service, 2000–01	
General Purpose as % of General Fund Revenues	7.1
Transportation as % of Transportation Fund Revenues	1.2
Total Debt Service Combined as % of Revenues	6.8

Amortization (%)	
Five Years	46
10 Years	80

*Includes this issue and \$42,000,000 bonds expected later this year.
G.O. – General obligation.

provisions with the Municipal Bond Bank and the Housing Finance Agency, the latter limited to \$125 million bonds; there have been no calls through this provision.

Short-term debt has been employed regularly, both for operating and capital purposes. In 1993–97, it was entirely in the form of commercial paper. Operations in 1997–98 were so favorable that operating debt was reduced to \$20 million, down from \$105 million in 1996–97, and the period of need was brief. There was then no need for operating borrowing until 2002–03 when \$75 million was issued. For 2003–04, \$48 million was issued.

Vermont has a capital debt affordability advisory committee that will recommend prudent debt authorizations, taking into account, among other things, debt in relation to personal income and debt service in relation to revenues. A range of \$75 million–\$100 million annually over the 1990s was set, but

amounts were lowered reflecting the recession. Annual amounts have declined from \$64 million in 1993–94 to \$43 million in 1996–97 and 1997–98 and to \$39 million in 1998–99 and 1999–2000, \$34 million 2000–01 and \$39 million recommended annually through 2002–03. The recommendation for 2004–05 is \$41 million. Authorizations have approximately matched recommendations.

The state will follow this issue of refunding bonds with \$42.2 million general obligations shortly. The state now makes annual bond authorizations, eliminating any overhang of authorized but unissued debt.

Debt ratios are well within the moderate range. Debt had been rising but the lower affordability level has now become evident. In addition, surplus has been directed to capital purposes, reducing borrowing. From 1992 to 1997, tax supported debt rose 29%, but excluding the deficit notes outstanding in 1992 the increase was 50% while personal income rose 26% over the period. Debt currently is about 15% below the 1997 level, while personal income rose 32% in 1997–2002.

■ Financial Operations

The general fund is the basic operating account. Accounting has been done on a cash basis, but the conversion to GAAP was completed for the 1996 fiscal year. Vermont's comprehensive annual financial report for fiscal 2002 was delayed until November 2003, due to complications of a new financial system and conversion to GAAP Statement 34. The 2003 report is expected in Spring 2004.

Vermont returned to surplus operations in 1995–96 which, when combined with a transfer from the transportation fund, eliminated the general fund deficit from the previous year. Vermont had deficit operations in 1991–93, returned to surplus in 1993–94, but again suffered a deficit in 1994–95 when revenues fell short of expectations.

In 1995–96, the original budget was modified to take account of the revenue shortfall experienced in the spring of 1995 and expenditures were cut. In fact, the personal income tax out-performed expectations and an operating surplus was achieved. For 1996–97, an exactly balanced budget was adopted, with modest revenue growth. Actually, revenues, spurred by the personal income tax, were more than 6% over estimates while spending was restrained. The general

fund had an operating surplus of almost \$50 million, which was basically retained in reserves, except for a \$4.9 million transfer to the transportation fund which had a small operating deficit. At June 30, 1997, the budget stabilization fund had a balance of \$35.1 million, \$7 million was in reserve for education and \$2.9 million was reserved for debt reduction. The transportation fund held \$7 million in its reserve.

Financial operations in the following years had been favorable, with revenues generally ahead of estimates, operating surpluses achieved and reserves accumulated. Additionally, significant appropriations were made for capital and other one time purposes. In 2000–01, growth slowed, with revenues up only 1.3% but an operating surplus of \$36 million was achieved. Personal income taxes rose about 4% and the sales tax was flat. Cigarette taxes, which totaled \$11.0 million in the previous year, no longer flow to the general fund but are deposited in the health care access trust fund. Reserves at year-end included \$43 million in the stabilization reserve, \$18 million in human services caseload reserve and \$31 million was reserved for other purposes, for a total of \$92.6 million. The transportation fund had a small operating surplus of \$6 million; at June 30, its stabilization reserve held \$8.9 million

The 2001–02 budget assumed that available revenue would be around the same level as in the previous year and operating surplus after transfers of \$23 million to the transportation and education funds was set at \$9.3 million. In fact, general fund revenues were about 7% lower than in 2000–01 and 10% below original estimates. The personal income tax was 11% below the previous year and 13% below original estimates, primarily due to the capital gains, options, etc., component. Revenue estimates were lowered twice during the year and in response, appropriations were reduced but the final shortfall dictated the use of \$29 million from the reserve, leaving \$17 million in that fund as well as \$18 million in the caseload reserve.

The budget for 2002–03 was promised on revenues of \$883 million but estimates were lowered in July; the gap was to be met from transfers and cuts. However, revenues actually matched the original level and in essence the transfers were added to reserves. Taxes for the year rose 3.1%, reflecting strength in insurance and estate taxes while the personal income tax was up only 0.9% and the sales tax, 1.8%. At the close of the year, the general fund stabilization reserve was about one-half funded at

\$23.5 million and the transportation reserve held \$9.2 million. A caseload reserve amounted to \$17.2 million. The education fund drew on its reserve, bringing it down to \$11.2 million.

The budget for 2003–04 expects moderate revenue growth of 3.8% in the personal income tax and 3.2% (underlying) in the sales tax. An operating surplus of nearly \$53 million is projected, all to be held in reserves that would then be fully funded. For the first six months, revenues are about \$21 million over estimates. The budget proposal for 2004–05 is in balance, with operating surpluses in the general and transportation funds and use of reserves for the education fund. Revenue estimates appear realistic. The governor has proposed a reduction in the personal income tax rate, to be held revenue neutral through closing of corporate tax loopholes and ending the partial exclusion of capital gains from the personal income tax. A long term issue involving \$150 million is a clean water program for pollution in lakes and streams.

The transportation and education funds are important in state operations. Transportation revenues have been favorable and its reserve is fully funded. The education fund, set up after court decision held the state responsible for the function, now receives various taxes, lottery proceeds, and general fund appropriations, and will be receiving one-third of sales taxes after 2004. It also collects a state wide property tax. Operations of the fund have often relied on use of its reserve.

■ Economic Base

Vermont's economy includes manufacturing, tourism and agriculture, although the latter has declined considerably in importance. Services now account for 39% of employment, followed by trade at 17% and manufacturing, mostly durables, 14%. Manufacturing declined in the 1990s recession, with employment dropping from over 50,000 in 1985 to the 43,000 level in the early 1990s. There was recovery, with 2000 manufacturing employment at 46,400, but slipping in 2001 to 45,550 and currently at 40,650. The state's largest employer continues to be IBM although there have been layoffs of some 1,800 over the past two years. A Canadian company, Husky

General and Special Revenue Funds (\$000, GAAP)

	1999–2000	2000–2001	2001–2002
Revenues	2,566,764	2,634,599	2,804,565
Taxes	1,529,510	1,590,016	1,600,725
Federal Aid	847,345	849,190	964,142
Expenditures	2,526,902	2,627,013	2,822,405
Education	844,920	883,907	1,035,570
Human Services	909,481	909,236	1,065,880
Transportation	266,797	294,265	311,133
Debt Service	74,855	73,895	69,214
Operating Result	39,862	7,586	(17,840)
General Fund Balance	110,681	172,757	149,594
Undesignated Balance	10,696	86,583	97,898

Injection Mold Systems, has established a presence here. Tourism is broad based, including several ski areas for winter attraction while scenic beauty and countryside encourage summer visitors. Several ski areas have undergone improvement, including a continuation of year-round use. The widespread second home and condominium usage already provides some stability. Canadian tourism and shopping is an economic factor and the weak Canadian dollar presents some weakness currently.

Employment in Vermont peaked in 1989 after a period of rapid growth. About 5% of employment was lost, only about half as severe as the losses in most New England states. By the end of 1994, the loss had been regained and 2000 employment was about 14% over the earlier peak. It remained at the same level in 2001 and there was a decline of 0.7% in 2002. In November 2003 compared to the same month a year ago, employment was up 0.5%, with increases of 2.3% in financial services, 0.7% in trade, 0.7% in government, 2% in construction, 1.1% in health and educational services, and 2.3% in leisure services; manufacturing was down 2.8%. Gains of 1.4% in 2003 and 0.4% in 2004 are expected. Unemployment is consistently low.

Through most of the 1990s, personal income growth in the state lagged the national experience. In the past few years, however, Vermont gains have exceeded those of the U.S., both in total and on a per capita basis. In second quarter 2003 state personal income rose 3.5%, compared with 1.5% in New England and 2.8% nationally. In 2002, Vermont's per capita personal income was equal to 96% of the U.S. figure, ranking it 24th.

Employment Trends

Employment
(000)

Unemployment Rate
(%)

	VT	% Change	U.S.	% Change	VT	U.S.	VT as % of U.S.
1980	200	—	90,406	—	6.4	7.1	90
1985	225	12.5	97,387	7.7	4.8	7.2	67
1988	256	12.4	105,210	8.0	2.8	5.5	51
1989	261	3.2	107,895	2.6	3.6	5.3	66
1990	257	(1.5)	109,419	1.4	5.0	5.5	91
1991	249	(3.1)	108,256	(1.1)	6.4	6.7	96
1992	251	0.8	108,604	0.3	6.6	7.4	89
1993	257	2.4	110,730	2.0	5.4	6.8	79
1994	264	2.7	114,172	3.1	4.7	6.1	77
1995	270	2.4	117,203	2.7	4.2	5.6	75
1996	275	1.9	119,554	2.0	4.6	5.4	85
1997	279	1.5	122,690	2.6	4.0	4.9	82
1998	285	2.2	125,865	2.6	3.4	4.5	76
1999	292	2.5	128,916	2.4	3.0	4.2	71
2000	299	2.4	131,720	2.2	3.0	4.0	75
2001	302	1.0	131,922	0.2	3.6	4.8	75
2002	300	(0.7)	130,791	(0.9)	3.7	5.8	60
November 2003	305	1.7	130,123	(0.5)	3.8	5.9	64

Personal Income
(Change from Prior Year)

Per Capita Income
(Change from Prior Year)

	—% Change— VT	U.S.	VT as % of U.S. Growth	—% Change— VT	U.S.	VT as % of U.S. Growth
1991	1.4	3.7	38	0.9	2.6	37
1992	6.5	6.1	107	5.9	4.9	120
1993	3.3	4.1	80	2.6	3.0	87
1994	4.8	5.0	96	3.9	4.0	98
1995	4.6	5.3	87	3.9	4.3	91
1996	5.0	5.6	89	4.4	4.6	96
1997	5.2	6.0	87	4.8	5.0	96
1998	7.2	7.1	101	6.6	4.9	135
1999	5.7	4.9	116	4.9	3.7	132
2000	7.8	8.0	98	6.6	6.7	99
2001	5.2	3.3	158	4.7	2.2	214
2002	3.1	2.8	111	2.5	1.4	179

Components of Personal Income: Earnings

	VT		% Change	U.S.		% Change
	1999	2001	1999–2001	1999	2001	1999–2001
Manufacturing	19	19	11	16	15	10
Durables*	14	14	14	10	9	1
FIRE	6	6	12	9	10	14
Services	29	30	13	29	30	14
Trade	15	15	13	15	15	9
Construction	7	7	13	6	6	14
Government	16	16	15	16	16	11

*Durables is a subhead of manufacturing.

State Population: 608,827 (2000)

Population Change 1990–2000: VT 8.2%; U.S. 13.2%

Personal Income Per Capita 2002: \$29,464 = 96% of U.S.; rank 24th.

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